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THE MARKET: Do you know the single most fantastic thing about the market? It is that there are no market experts. True, there are brilliant students, there are highly successful investors, but there are NO experts.

One of the things that I have had to learn when dealing with markets is that any person, any analyst, any man or woman professional or otherwise can at any given time be DEAD WRONG. I've watched and studied so-called experts for four decades. I've seen presidents, treasury secretaries, Fed chairmen, advisory writers with national followings, Wall Street "geniuses", money-manager heroes -- I've seen them all pitifully wrong at various times.

And that is probably the most fascinating thing about Wall Street. It makes humble men and women of us all. Or else, it renders us fools. I will put it in a stronger way. There's a bit of Wall Street lore which I often turn to -- and it goes like this: "Watch the Wall Street guru who has been right for a long period. At the time of his greatest following and fame, he is most apt to be completely wrong. Conversely, watch the advisor who has been wrong for a long time. Just about the time when everybody ridicules him and writes him off, that's the time when he is most likely to be right."

As far as I'm concerned, there is only one real teacher in this business, and that teacher is the market itself. Which brings up the old Dow Theory principle that states, "What everybody knows is superior to what any one person knows." In other words, when you follow the action of the market you are in reality tuned in to all the economic, business and financial knowledge available.

Perhaps William Hamilton put it best when he wrote in his great book, "The Stock Market Barometer," "This is why the stock market barometer is so valuable. It makes little of cycles or systems, interesting and even well-grounded inferences or common fads. It uses them all so far as they are useful, together with every other scrap of information it is possible to collect. The market movement reflects all the real knowledge available, and every day's trading sifts the wheat from the chaff."

So I've learned over the years to give number one priority to the action and the indications of the market itself. In other words, if the information doesn't come from the market itself, I'm skeptical. I've been fooled too many times by so-called Wall Street experts and economists with bright credentials. The best time, the most fruitful time, the most profitable hours I've spent in this business, is the time I've spent alone studying market action. The pot of gold for the average investor lies in his ability to read, to interpret and to understand the markets.

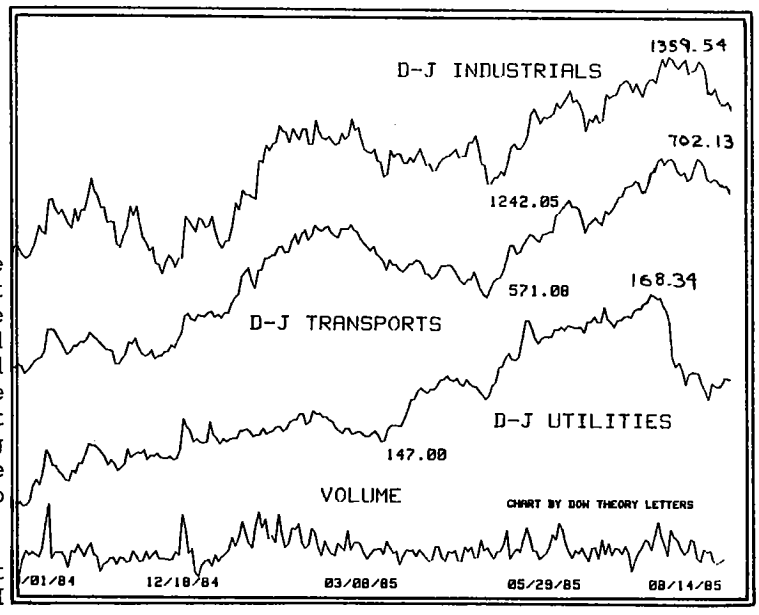
All right, having said all that let's turn to the market itself. And let's start with the bad news. What do I like least about this market? I like least the action of the D-J Utility Average. This Average hit a record high of 168.65 on July 15. Since then the Utilities have been in a swan dive, dropping to 153.11 on August 7.

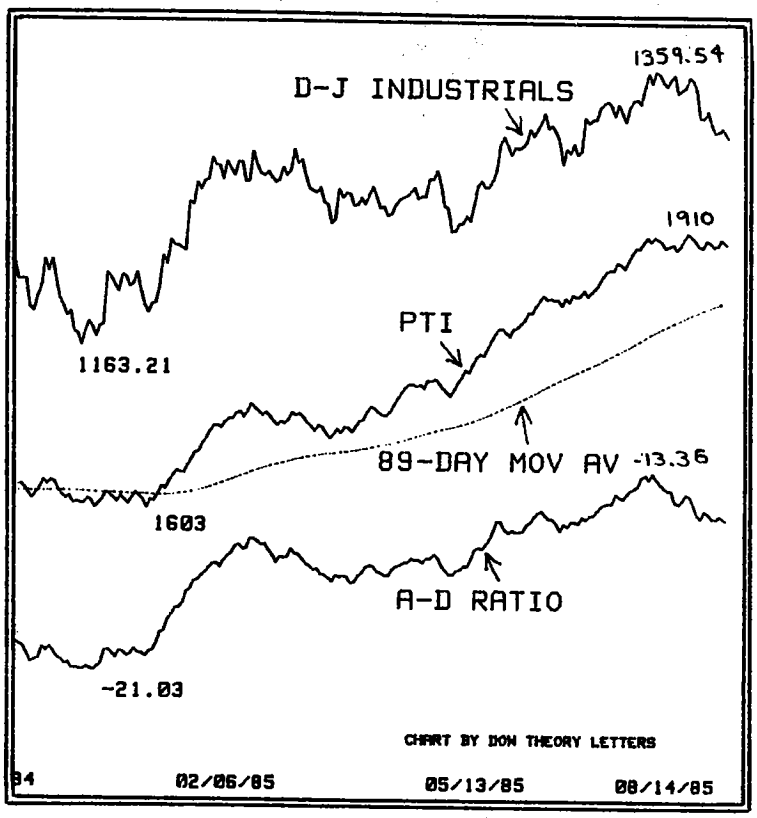
Of course, the Utility rise from the 122.25 June 1984 low to the record 1985 high of 168.65 was tremendous, being a rise of 38% in a period of a little over a year. A normal correction under Dow Theory calls for a retracement of one-third to two-thirds of the previously uncorrected advance. Thus, a simple one-third correction of the 1984-85 Utility rise would call for a drop to the 150 level, a drop which was essentially achieved at the August 7 low.

Nevertheless, the Utility Average does tend to be a bellwether for the market, and no one likes to see it "fall out of bed" as it did over the past month. Many feel the Utility action is a preview of the topping out of the entire bull market. Maybe so, but I certainly don't buy that thesis yet.

Another widely discussed negative is the steady drop-off in daily new highs on the NYSE. On May 20 we had a peak of 454 daily new highs. Then on June 5 (with the Dow higher) new highs dropped to 322. On June 27 new highs sank to 102. On July 19 (with the Dow at its record high of 1359.54) we saw 133 new highs. Not very impressive -- and conceivably a dangerous development. But how dangerous? The big question is -- are we seeing a long-overdue correction, or a major bear market? I opt for a correction.

In Letter 917 (page 4) I explained why the last thing I would want to see here would be a big market move on





the upside. I stated that the best thing that could happen would be a "period of gestation in which business reliquefied, earnings increased and stocks simply marked time." I continue to feel this way, and if it takes a market correction here to hold buyers back and to dampen enthusiasm, well, I think it would be a healthy development -- far better for the stock market and the nation than a new speculative stock boom.

What do we have on the positive side? The strongest item we have is the direction of the great primary trend of the market -- which I classify as bullish. In recent Letters I have underscored the fact that new historic highs in the D-J Industrial and Transportation Averages constitute re-confirmations of the primary bull trend. But the extraordinary thing about those new highs is that they arrived amid such general gloom on Wall Street.

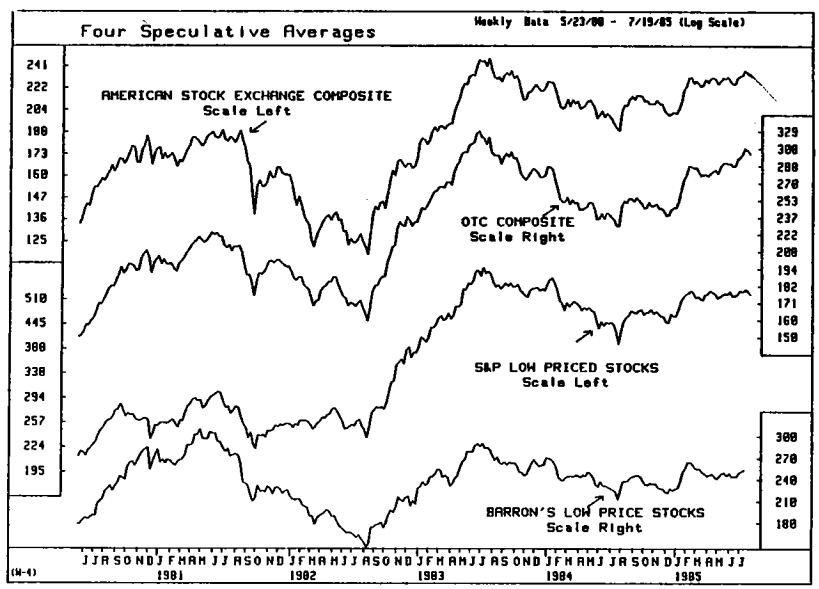
Bob Prechter (Elliott Wave Theorist, PO Box 1618, Gainesville, GA 30503) in his latest report writes, "If this is a major top, it's like no other major top in history. The public is so disenchanted with stocks that brokers are suffering and the market letter industry as a whole is in an out-and-out depression." Happily the depression has not hit Dow Theory Letters, but Bob is basically correct, and I have been hearing sighs and cries from all sides. In view of the record highs in almost all the major Averages during July, I was amazed by the lack of enthusiasm on the part of the public and on the part of Wall Street. The only comparable action I can remember is during early 1958 when the economy was slowly coming out of a very severe recession. People positively hated the stock market during the first part of 1958, even though the market was climbing relentlessly upward.

The crux of it is that we are seeing a confirmed (and re-confirmed) bull market that has failed to stir up investor or speculative excitement. I don't think I've ever seen a major bull market that didn't froth and foam near the top, and my guess is that ultimately this one won't be any different.

This chart includes four speculative stock averages, and I think it makes my point (chart courtesy of Ned Davis, 3312 Piedmont Rd NE, Atlanta, GA 30305). Note that since mid-1983 there has been little in the way of excitement, as gauged by any of these four averages. None of them, in fact, has even bettered its 1983 highs, despite successive new highs in the Dow, the S&P 500, the NYSE Composite and the Wilshire 5,000. But market history tells us that during the speculative, final phase of a big bull market the low-priced and speculative averages make huge advances. This occurs because it is then that the public comes in with both feet, buying anything that looks "cheap" and pushing low-priced issues through the roof. We have seen nothing like that during 1984 or 1985.

In recent Letters I have noted that the PTI was over-extended on the upside and needed corrective action or at least a rest. Throughout the weakness since mid-July the PTI has held up remarkably well. The peak for the PTI was recorded at 1910 on August 1, following an uncorrected 200-point rise. As this is written the PTI is still a whopping 66 points above its 89-day moving average so that more corrective action can be expected (see page 2 chart). Nevertheless, it is notable that the PTI has, so far, been very resistant to decline -- despite weakness in both the Dow and the A-D ratio.

Sundry Market Comments: (1) Bob Prechter in his latest Elliott Wave report notes that we are in the third wave of a bull market, and that during third waves, market breadth is seldom impressive. Thus, he warned many months ago not to expect big upside breadth action ahead. Events have proved Prechter correct. And that's one reason why I have been recommending only the strongest Dow stocks for purchase. If the Dow advances (which it ultimately must in a bull market), then it must also be led by the strongest components of the Dow.



(2) In the latest Merrill Lynch Strategy report they include a long-term chart of T-bill yield divided by the yield on the S&P 500 Composite. Each time this ratio has dropped to 1.6 or below, a recession has started or been in progress -- and at the same time the stock market (having discounted the recession) has hit approximate bottom. The June ratio was just above 1.6, indicating that a recession is in progress and also indicating that the stock market has probably discounted most of the recession. In my own opinion, a recession of sorts has been in force for a year, and the stock market has been well aware of it.

(3) The Bank Credit Analyst's debit/loan ratio compares all bank checking activity as a ratio of loans outstanding. When the ratio moves down it means that activity is declining in relation to loans, and this increasing liquidity is bearish. Conversely, when the ratio rises it means that activity is increasing in relation to loans -- which is bullish. After dropping sharply since mid-1983, the debit/loan ratio is now rising. This presents a positive background for equities, although the effects of this reliquefication may take some time before showing up in corporate profits (which are, in general, dreadful at the moment).

INVESTMENT POSITION: The bull remains in the box. The D-J Utility Average now looks as if it wants to bottom out. As of August 16, the A-D ratio (NYSE) was down 15 out of 19 days, and thus the market is moving toward an over-sold condition (based on an intense plurality of declining days). These are hints of renewed inflation as the dollar sinks and as the CRB Commodity Index gives indications of groping for a bottom (see gold section on page 6).

I don't see anything really intelligent to do here except sit tight with our positions. It's a case of "Don't do something, just stand there." Oh yes, I continue to be surprised by the strength of the PTI. So far, it just doesn't want to follow this market down.

BOND PERSPECTIVE: Here on a single 1X3 point & figure chart is the entire history (!) of the D-J Bond Average (chart courtesy of Chartcraft, Larchmont, NY). Each box on this chart equals 1 point on the Bond Average, and only rallies and declines of 3 points or more are shown.

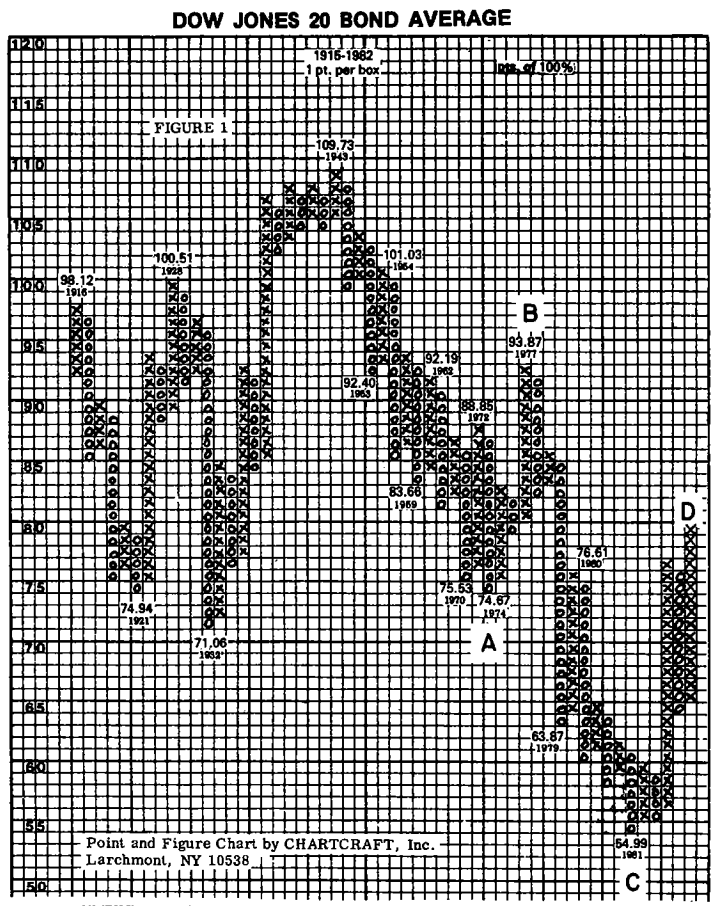
A bear market in the bonds occurred between 1928 and 1932. The bear market took the Bond Average from 100.51 down to the 1932 Depression low of 71.06. From there a bull market carried the Bonds to 106.73 in 1943. World War II entered the picture, the Depression ended and the era of massive deficit spending and rising Federal debt began. A massive bond bear market began in 1943. It continued for decades.

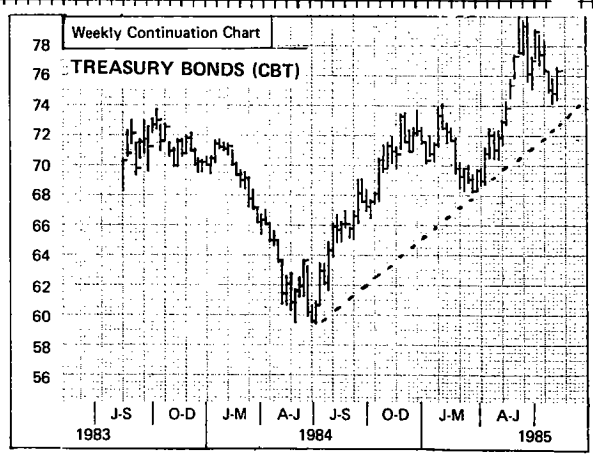
The Bond Average sank to a low of 74.67 in 1974, whereupon a big bear market rally started. The peak was hit in 1977 at 93.87. From there the Bond Average had dropped to an historic low of 54.99. The loss in the Bond Average from the 1943 high to the 1981 low was an unbelievable 49%.

From the 1981 low a new advance began. A month ago, on July 16, the D-J 20 Bond Average hit a high of 80.65 -- then stalled. The Bond Average stalled at a critical and strategic level. I say this because the 50% Principle now comes to the fore. The 50% Principle states that if the price action, following a major and extended decline, can recover 50% or more of the ground lost, it is technically possible that the momentum will take the price near or even above the old high.

The halfway level of the entire 1943 to 1981 bear market is 82.36, roughly 3 points above where the Bond Average is now. A decisive move above 82.36 would, in my opinion, have very bullish implications for bonds and interest rates. Conversely, a move down from this area could indicate that the bear market in bonds had taken hold again -- or that a new primary bear market had started.

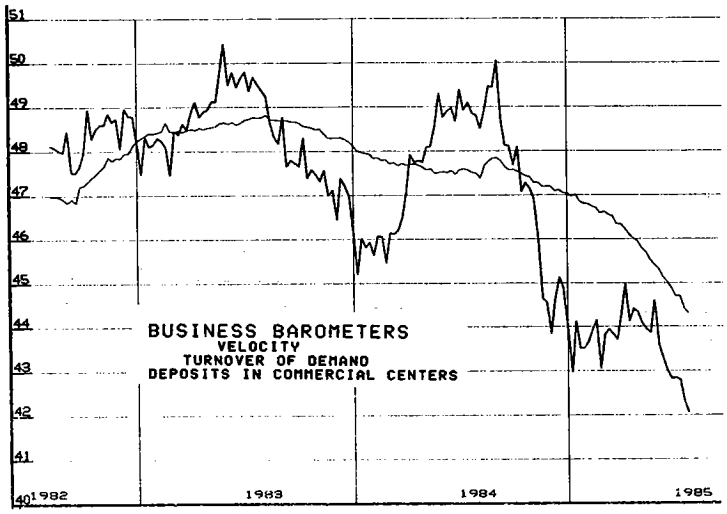
From a closer perspective, this is a weekly chart of the T-bond futures (courtesy of Dunn & Hargitt). Note that the rising trend has held well, at least so far, and this despite continued massive Treasury financing. It would





take a decline below 73 on the near-term T-bond contract to violate the bull trend. That hasn't happened yet. And Richard Russell hasn't sold his bonds yet.

COULD THIS BE HAPPENING? Why has the Fed been flooding the money supply, and why hasn't the flood set off the forces of inflation and boom? One answer may be that transactions at the banks (demand turnover) have been sagging badly, as this chart from Mansfield so dramatically indicates.



In other words, the Fed may have been opening the monetary spigots to make up for the collapse in the velocity of money. But if activity has been so sluggish, why is the stock market holding up, and why is gold looking stronger (suggestive of coming inflation?). Answer: The stock market and the gold market are looking ahead; they are carefully weighing the picture, and what they see ahead is (1) business turning up in late-1985 or 1986, and (2) the forces of inflation starting to appear again.

"Ah," you retort, "but if business is going to pick up along with inflation, shouldn't bonds head down?" And my answer is, "Yes, they should." So let's watch for the following scenario -- a firm stock market, rising precious metals and declining bonds along with gradually rising interest rates. That's not a prediction, it's a list of three items to watch for in coming months.

INVESTMENT PHILOSOPHY: Many readers have asked me, "Russell, how do you decide what you are going to write in any given Letter?" and my answer is twofold: (1) I write about what I actually see happening in the market. For instance, if bonds look toppy or gold appears to be breaking out, I'll write about that. (2) I write about what I happen to be thinking about. For instance, if I am thinking about values or stock selection, that's what I write about.

This week I've been thinking about one of my favorite subjects: diversification. Except in rare instances, I feel diversification is a MUST in investing. What are examples of rare exceptions? Well in 1958 and again in late-1974, I was so convinced that the market was going much higher that I put all my eggs in a single basket, and that basket consisted of common stocks. Again in mid-1984, I was convinced that bonds were ridiculously undervalued compared with stocks, and I put all my market money into bonds (as subscribers well know). Happily, my judgment paid off and bonds made an historic move to the upside. But those three instances were rare, very rare.

In general, I opt for diversification, and I feel that in the vast majority of cases diversification will serve my subscribers well. Of course, there's always the problem of "diversifying into what?" And "What proportion should I place in what category?" And here, all I can give you is my philosophy in broad terms.

For instance, I feel the broad diversification categories are (1) home, an asset not available to everyone. (2) Hard assets such as gold, silver, art, stamps, etc. (3) Bonds, and here you can choose bond funds, unit trusts, munis, closed-end funds, T-bonds, corporate bonds. (4) Stocks, and again you can choose individual stocks, no-load funds, closed-end funds.

I find that for the average subscriber it helps to keep it simple. So I'm going to present a very simple mix that may solve a lot of problems (call this a widow's mix). Put (1) 20% of your available assets into a good no-load fund such as Newberger Berman's Guardian Mutual (800-367-0770) or Fidelity Equity-Income (800-225-6190). (2) Put 10% into gold coins and gold shares (Maple Leafs, Campbell Red Lake and Homestake). (3) Put 20% into a closed-end fund listed on the NYSE such as Lehman Corp or Tri-Continental. (4) Put 25% into 10-year Treasury bonds. (5) Put 25% into the General Obligation muni bonds from your own state. There, that adds up to 100%, and such a portfolio will tend to keep you out of trouble and will probably do better for you than all the trading and switching around that you can possibly think up for yourself.

Note that I am talking about available funds, and I am not including assets such as your home. I also feel that every man with a family should have some kind of life insurance (the less your assets, the greater your need for insurance). Remember, insurance is the only vehicle that provides you with an instant estate, even though you pay later.

One final comment here regarding time. When you are young (or youngish) you have one huge advantage -- you have time ahead of you. This is extremely favorable for compounding. The biggest mistake a young person can make is to go into debt. The best move a young person can make is to build assets while he is young and then compound. Sadly, young people usually do exactly the opposite (a typical example is a young couple who marry, then immediately buy a house while borrowing heavily to do so). Remember the old Russell adage: Any time you borrow you are making money for somebody else ; any time you save and compound, you are making money for yourself.

NOTES & QUOTES: From our "Now It Can Be Told" Dept: →

Former Budget Director David A. Stockman said that the Reagan Administration has lost its last chance to control the federal deficit, leaving the nation headed toward economic instability. Stockman, in an interview for the Sept. 2 issue of Fortune magazine, said there was virtually no chance Congress or the Administration will adopt the politically painful spending cuts or tax increases necessary to bring the deficit below $200 billion a year. The budget resolution Congress adopted Aug. 2, Stockman said, is a "limp rag" that fails to plug the gap. "Basically, the window of opportunity has closed," he said, citing the Administration's lack of leadership, Congress' refusal to sacrifice pork-barrel programs and his own tactical errors as reasons for the failure.

* *

I know President Reagan means well, but ponder this. While Governor of California, Reagan (1967 to 1975) signed into law two of the largest state tax increases in the nation's history. And more recently, while president, Reagan has presided over the biggest federal deficits in the nation's history. But fear not. In a few months, Mr. Reagan says, "We intend to launch a major fall offensive, going to the people and working with Congress to achieve major and much-needed reforms." I'm beginning to wonder how much those "reforms" are going to cost us.

* *

From our "It Ain't What You Say" Dept: Practically monthly, Fed Chairman Volcker berates the Congress for failing to cut the deficit. Yet this piece from the August 8 WSJ suggests that Mr. Volcker and the Fed could set an example by doing a little cutting at home!

> —At the Federal Reserve Board, employees have the benefit of their own full-time fine-arts coordinator. Her job, at a salary of $37,943 a year, is to arrange for art displays in the entrance and main hall leading to the Fed governors' boardroom. The Fed may also hold the record for most private dining rooms per capita in Washington. It has five, including separate ones for Chairman Paul Volcker and for the rest of the Fed board.

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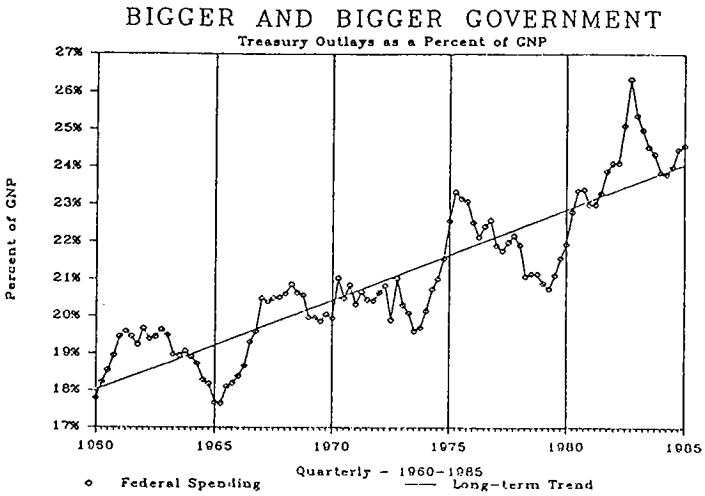
Here's another milestone for capitalism. Thanks to the Fraser Opinion Letter for bringing this to our attention:



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In a fascinating article Dunn's Business Month interviews Thomas Horton, president of American Management Association. Horton talks about management views in various nations. The US goes for "shoot it out". In the US management is highly competitive, big rewards for success, little punishment for failure.

Japanese: "Get it right the first time." Great cooperation at the top and unmatched cooperation between banks and companies. Japanese love to improve things.

British: "Muddling through." British caught up in the past, the "old boy network" reigns supreme.

Russians: "Cover it up." The world's biggest bureaucracy. The plan is everything. They are good at vast projects, but terrible at meeting consumer needs. Horrendous demand/supply mismatch.

* *

From our "Now It Can Be Told" Dept.: The word is that the White House has come down to the power of two men, Ronald Reagan and former Merrill Lynch CEO Don Regan. The 66-year-old Regan has now consolidated his power, and many feel that he has the power but not the ability to run the government (although many believe Regan is now trying to do exactly that). In an August 5 front-page story, the LA Times examined the Reagan-Regan ministry and a few comments from that article are eye-openers. Read it and weep:

"The good guys are leaving and the personnel situation is in a mess," said a key Republican congressman and longtime Reagan supporter who asked not to be named. "You've got the budget problems, and the tax thing is coming unglued.

"The other morning a bunch of freshmen House Republicans met with Regan and Baker and beat up on them on tax reform. They told them they had been home and nobody wanted to know about tax reform, they wanted to know about the deficit. Getting that from junior House Republicans should give you a feel for the White House nowadays."

Similarly, Reagan received a frosty reception last week when he arrived for a White House session with Republican leaders of Congress to explain his rejection of the deficit reduction package proposed by Senate Republicans.

"Ordinarily there would have been some applause when he entered the room—and you would have expected more than usual because it was the first time most of us had seen him since the surgery," one Republican said. "But there was no applause, and it was one of the most tense meetings I've ever been to at the White House."

Reagan Put on Notice

A Republican House leader said Senate Budget Committee Chairman Pete V. Domenici (R-N.M.), glancing at Regan as he addressed the President, put Reagan on notice that he will insist next year that the White House recognize the need for including taxes, benefit programs and the Defense Department in deficit reduction.

Domenici was quoted as saying: "I want you to know, Mr. President, it's the last time I'll do this. I want to make it clear to you and all your advisers in the room that I will not go through with this coverup again."

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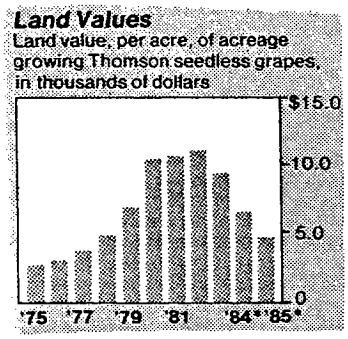


California Farming Notes: Many California farmers are reeling from the quadruple whammy of falling commodity prices, rising imports, dwindling foreign markets and staggering bank debt. The farm troubles are hitting the banks as well. For instance, BankAmerica reported a staggering quarterly loss of $334 million. The bank is the state's largest holder of farm land with 94,000 foreclosed acres in its portfolio. Its farm loan portfolio is $2.2 billion. This little chart shows what has happened to land values for California farmers growing seedless grapes. From a high of $10,840, the acre price has sunk to below $5,000. If inflation is on the horizon, you don't see it on the California farms.

* *

We just got back from the Vancouver ISI Conference, and I must say I had a lot of fun. Spent a good deal of time with my old friend (gad, I've known him for 25 years), Sir Harry Schultz. Harry and I looked at each other and gasped, "Can we believe we've both been in this crazy business for a quarter of a century?!"

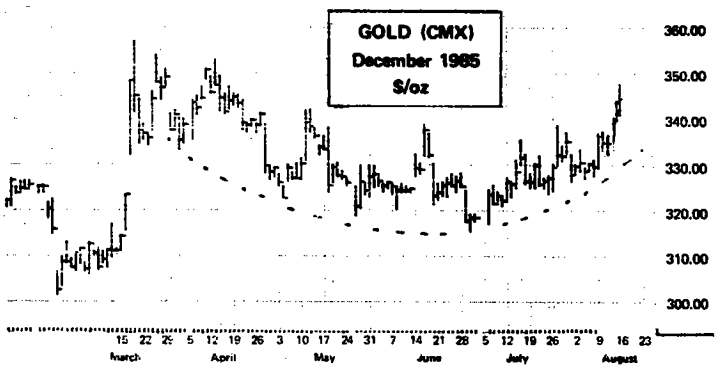
Ah well, we had a great time. Vancouver is a lovely city, laid-back, clean, wide streets, gorgeous harbor, beautiful downtown area, very international. Huge Chinese and Japanese population in Vancouver which automatically means great Oriental food. The city is getting ready for Expo 86, and the Expo buildings are breathtaking.For a city to visit (and the buck is worth $1.36 in Canada) put Vancouver near the head of my list.

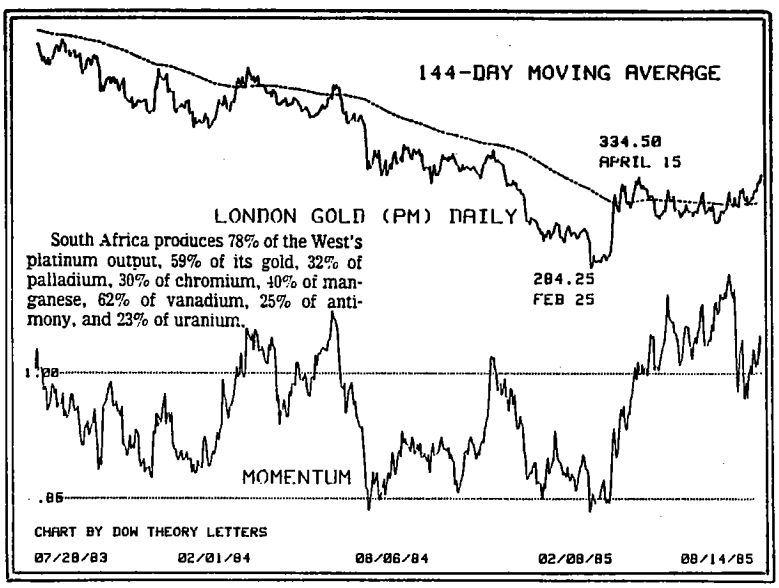
Maybe it's renewed seminar interest brought on by rising gold -- but I just spoke to the guys who are putting on the big NCMR Seminar in November (New Orleans) and they tell me they are running 32% ahead of last year in admissions. The lineup for the New Orleans conference (you just received a brochure) is extraordinary.

GOLD: The gold picture has changed. On August 16 my much-talked about gold level of 334.50 was bettered in the spot market. Even more dramatic was the $24 rise in platinum. But let's examine gold more closely. There's no doubt about it -- the first bull signal has been given.

The daily chart (December futures) (courtesy of Dunn & Hargitt) shows the saucer bottom in the yellow metal. On August 16 all preceding peaks going back to April were bettered. For a clean breakout I would want to see the December contract rise to the 360 level, but the action last week was impressive.

The next daily chart (spot gold) shows the metal along with its 144-day moving average. Over the last three months the moving average has finally flattened out, and last week's action saw gold push away from the moving average and above its 334.50 April 15 high. At the same time the momentum line (89-day rate-of-change) held persistently above the 1.00 level, meaning that gold was holding steadily above its price of 89 days ago. Such action is bullish.





Finally gold has now passed a test that I have often mentioned (see chart in the last Letter, page 6). The ratio of gold to common stocks (the latter represented by S&P 500) has now reversed in favor of gold. Superior relative strength in gold (compared with common stocks) presents a positive background for the yellow metal. In almost all cases, major rises in gold have begun with the metal acting better than common stocks on a relative strength basis.

The amateur investor will immediately ask, "What's causing the gold rise?" And my answer is, "No one really knows." The conservatives will claim it is the flooding M-1 statistics and its intimation of inflation. The gold skeptics will say it is simply the political degeneration of South Africa, a situation which could threaten gold mine (and platinum mine) production. Others may say it is the precarious condition of the US banking system. But from the investor's standpoint it really doesn't much matter what is causing the rise in the price of the precious metals. The only operative fact is that the underlying conditions in the metals market are changing.

What to do: Subscribers who want to ride the gold trend can (1) buy coins and preferably the Canadian Maple Leaf which is composed of 1 pure ounce of gold, (2) buy gold futures, say a December gold contract, (3) buy gold shares such as Campbell Red Lake, or buy a gold fund. The trouble with the latter is that almost all gold funds have some S. African gold shares in their mix, and that could be more of a minus than a plus. Of course, the conservative and safest way to participate in the gold market is to buy the coins. Here you don't have to worry about timing or the politics of S. Africa. Nor do you have to worry about the intricacies of the mining business. Nor do you have to worry about margins.

And finally, for the survivalist, the coins represent money (value) outside the system. In the final analysis, gold coins in the bank vault (or any other vault) may represent the ultimate in wealth. For unlike the dollar, unlike a stock, unlike a bond, gold itself represents the immutable, the unchangeable. Gold owes nobody anything, and it depends on no government edict to proclaim its value. A thousand years from now gold will still be money. I can't say that about anything else or any other item. Gold will be money when all the politicians who ever fought the yellow metal are just a footnote in ancient history.

LATE NOTES: In recent Letters I opined that there was a 50/50 chance of a bull market secondary correction. Based on what I see so far, I'm raising the odds for a full correction to 75/25. In other words, I think it's going to happen. If the market goes into the slide, my guess is also that it will bottom in the October-November period. More and more, this whole situation reminds me of 1957-58. On the plus side -- new lows have not (so far) come in, and bonds have held up better than I expected.

NEXT MAILING: September 5